Some comments on hub and spoke cases

Matthew Bennett
Director of Economics, OFT

CRA Brussels, December 2010

Views expressed are personal and not necessarily those of the OFT

Structure

- Overview
- Economics of hub and spoke
- Law of hub and spoke
- Conclusions

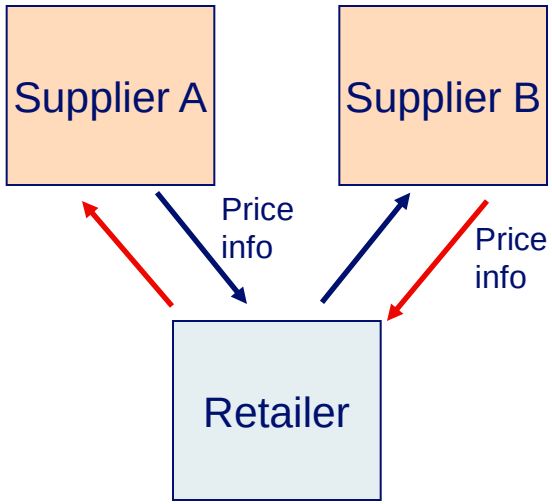
Why hub and spoke enforcement?

- **Want to prevent firms from colluding.**
  - Therefore rule out agreements between firms to set prices.
- **But what happens if firms just talk about intentions without explicitly agreeing to collude?**
  - Don't want firms to be able to bypass law.
  - Thus may want to take hard line on some exchanges, e.g. future pricing intentions between competitors.
- **What happens if firms have same discussion through third parties?**
  - Again – don't want firms to bypass law.
  - Thus may be concerned by some discussions of prices between independent parties if believe they are intended to be passed on to rivals.

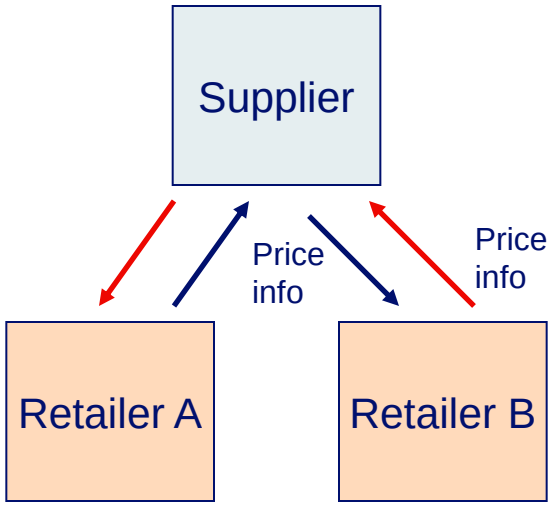
The economics of hub and spoke

Two broad cases of hub and spoke

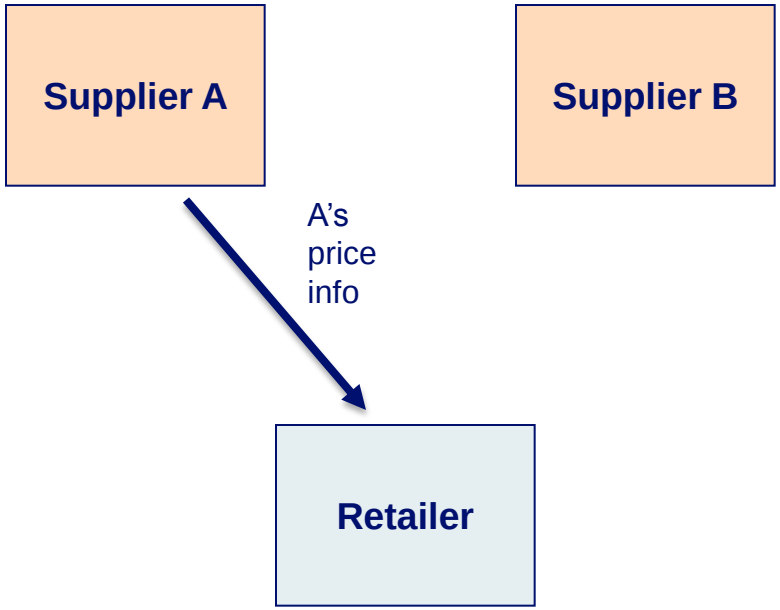
Supplier to Retailer to Supplier



Retailer to Supplier to Retailer

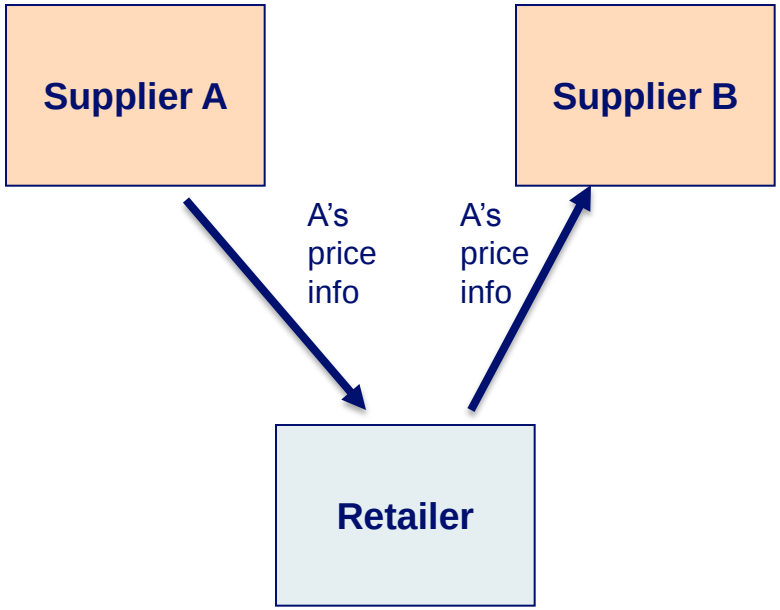


Supplier to Retailer to Supplier Theory of harm



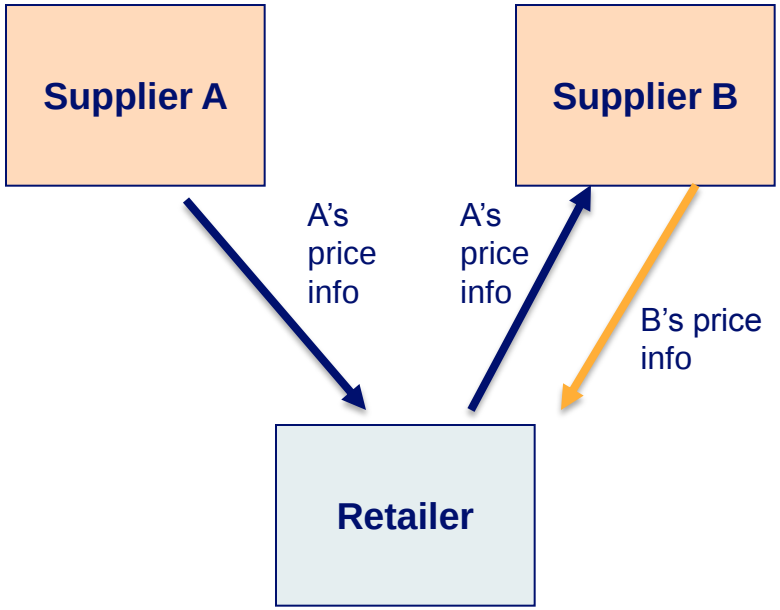
- **Flow of information may allow coordinated outcomes between suppliers.**

Supplier to Retailer to Supplier Theory of harm



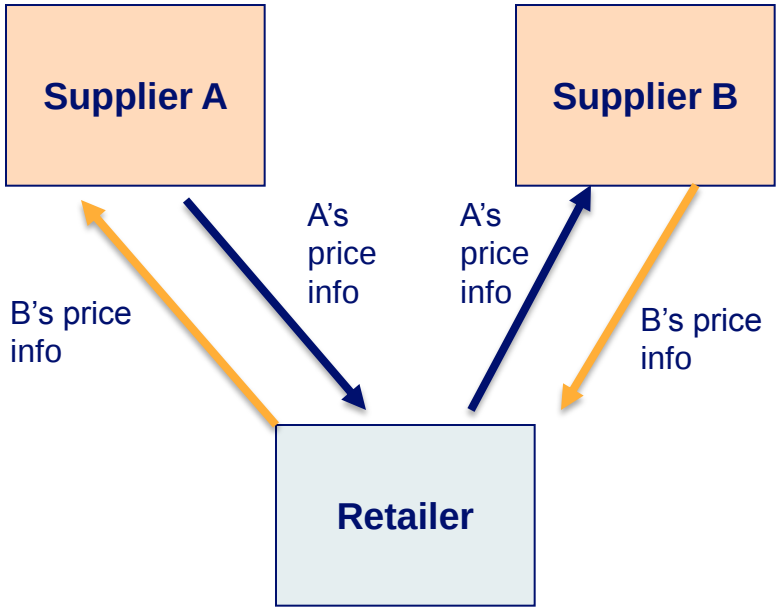
- **Flow of information may allow coordinated outcomes between suppliers.**

Supplier to Retailer to Supplier Theory of harm



- **Flow of information may allow coordinated outcomes between suppliers.**

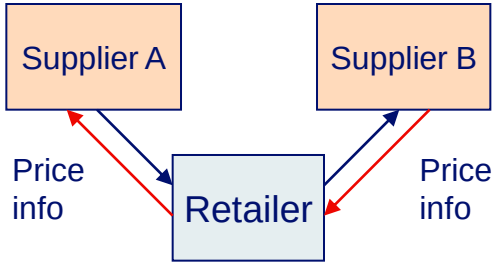
Supplier to Retailer to Supplier Theory of harm



- **Flow of information may allow coordinated outcomes between suppliers.**

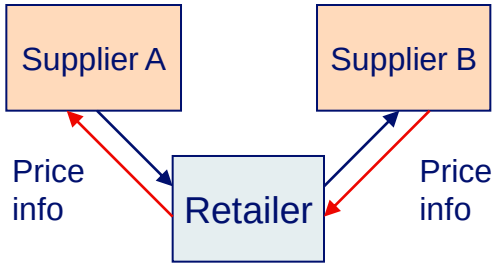
Supplier to Retailer to Supplier
Retailer incentives to participate?

- **In simple model may not expect retailers to have an incentive to pass through information that facilitates higher supplier prices:**
  - It directly increases their costs and hence reduces their profits (even if all their competitors follow).



Supplier to Retailer to Supplier
Retailer incentives to participate?

- **In simple model may not expect retailers to have an incentive to pass through information that facilitates higher supplier prices:**
  - It directly increases their costs and hence reduces their profits (even if all their competitors follow).
- **However retailers may still act as a conduit for exchanges:**
  - If suppliers have market power (must have) retailers may have little choice.
  - Non-linear prices - Suppliers may provide retailers with discounts or rebates (e.g. side payments) to provide retailers with incentives.
  - Retailers may be focused on ensuring parity between their rivals rather than lower input prices for themselves.



Supplier to Retailer to Supplier Pro-competitive effects

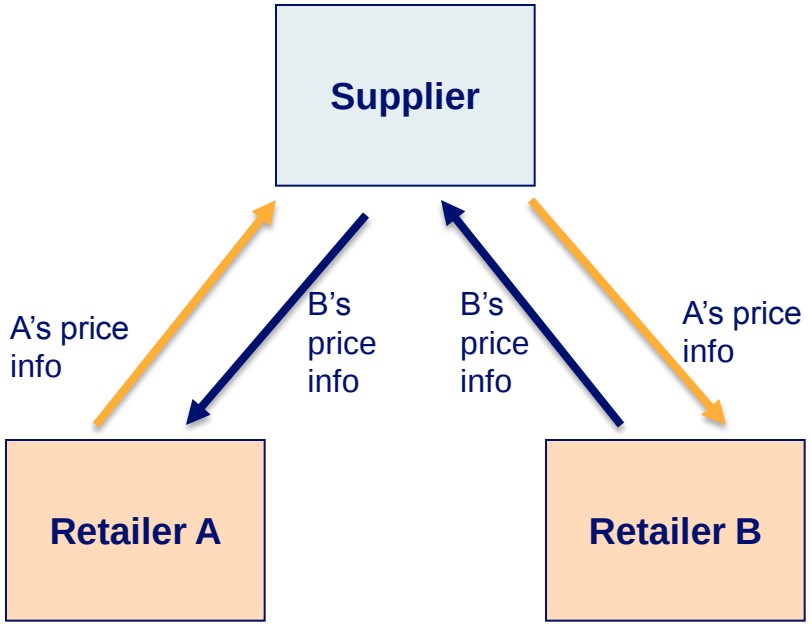
Pro-competitive effects

- **Competitive S2R2S facilitated exchanges may be very common indeed even more so than direct exchanges.**
  - Retailers will regularly go back and forth to suppliers to get the best possible price from a supplier.
  - Retailers may quote prices from a supplier's competitor in order to negotiate a lower price from the supplier.
  - Ruling out such behaviour may rule out retailers' ability to bargain.

Balancing

- **Over all suggests one should be more cautious in pursuing an indirect exchange of information via a retailer than a direct exchange.**
  - There are reduced incentives for retailers to facilitate them (relative to direct exchanges).
  - There are much more frequent and stronger benefits.
- **However this does not mean cases do not exist!**

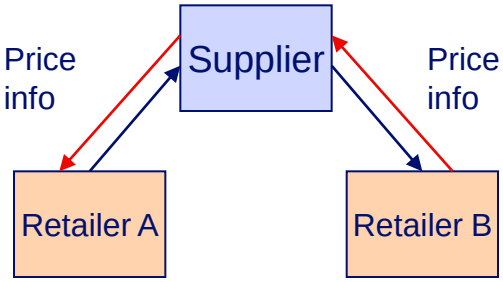
Retailer to Supplier to Retailer Theory of harm



- **Flow of information may allow coordinated outcomes between retailers.**

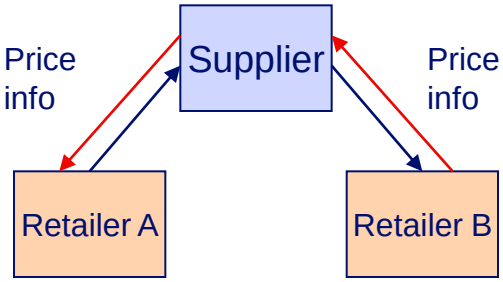
Retailer to Supplier to Retailer Supplier Incentives?

- **Suppliers may not want to pass information that facilitates higher retailer prices:**
  - It increases retailer price, reduces retail sales and hence demand and thus reduces supplier profits, even if all rivals follow.



Retailer to Supplier to Retailer Supplier Incentives?

- **Suppliers may not want to pass information that facilitates higher retailer prices:**
  - It increases retailer price, reduces retail sales and hence demand and thus reduces supplier profits, even if all rivals follow.
- **But suppliers may still facilitate exchanges:**
  - Bargaining power - if suppliers need access to retailers (must have) then suppliers may have little choice.
  - Retailers may provide suppliers with side payments in order to facilitate this – enhanced with networks of exchanges.
  - Suppliers may focus on ensuring parity with rivals rather than lower prices for themselves.
  - Reduction in bargaining power (see next slide).



Retailer to Supplier to Retailer Reduction in retailer bargaining?

- **Supplier bargaining power story behind supplier incentives?**
  - By reducing competition between retailers, manufacturers may soften retailers' bargaining power.
  - If all retailers charge the same price, then they have less incentive to negotiate lower input prices from manufacturers.
  - By ensuring a common retail price means no retailer can translate a wholesale cost advantage into a retail price differential and thus less incentive to bargain on wholesale prices(assuming there is a cost to bargaining).
  - Therefore a common retail price may increase the share of pie that the supplier gets.
- **Does this provide sufficient incentives to pass through information?**

Retailer to Supplier to Retailer Pro-competitive effects?

Pro-competitive effects:

- **Pro-competitive R2S2R facilitated exchanges may be more common than direct exchanges, but less common than S2R2S.**
  - When suppliers have limited resources which they need to allocate between retailers they may use the offer price of one retailer in order to negotiate with another retailer.
  - When suppliers have a high value brand, they may have an incentive to have a high retail price in order to protect that brand – therefore prevent discounting.

Balancing?

- **Over all suggests one may still be more cautious about pursuing these cases than direct exchanges, but one might worry more about these than S2R2S cases.**

The UK law in hub and spoke

What does the economics say about designing a law?

Want to differentiate between pro-competitive and anti-competitive

- **Pro-competitive**
  - Use of information in order to bargain and extract lower prices which can be passed on downstream.
- **Anti-competitive**
  - One party giving information to another knowing that (or expecting that), it will be passed on to its competitor in order to coordinate.
- **Differentiator regarding to knowing or expectation?**
  - In pro-competitive case there is no expectation from firm that its information will be passed onto its rival.
  - In anti-competitive case there is the expectation it is passed to rival.
- **Thus use evidence of expectations of being passed on?**

The UK test: Three limb test

Limb 1: A to B

A discloses future pricing information to B in circumstances such that A can be assumed to intend, or does intend, that B will pass onto C

The UK test: Three limb test

Limb 1: A to B	*Limb 2: B to C*
A discloses future pricing information to B in circumstances such that A can be assumed to intend, or does intend, that B will pass onto C	B passes info to C in circumstances such that C may be taken to know context in which it was passed on, and/or information is passed on with As understanding.

The UK test: Three limb test

Limb 1: A to B	*Limb 2: B to C*	*Limb 3: Use by C*
A discloses future pricing information to B in circumstances such that A can be assumed to intend, or does intend, that B will pass onto C	B passes info to C in circumstances such that C may be taken to know context in which it was passed on, and/or information is passed on with As understanding.	C uses the information in determining its own future pricing intentions

Conclusion on A2B2C cases

- **All A2B2C cases can have the same anti-competitive effects as direct exchange cases - coordination.**
  - However conduits may have incentives to resist these anti-competitive effects.
  - In addition there may be pro-competitive stories regarding bargaining – particularly with regards to R2S2R cases.
- **Need for legal test that differentiates.**
  - Legal test requirement of knowing/expectation that it will be passed on, attempts to do this.
  - Minimises cases of pro-competitive exchanges being wrongly prosecuted.
- **Should conduit's incentives play a role?**

Thank-you

Any questions?